Health and Welfare
Nondiscrimination Testing:
Forecast of an Eventual Requirement

Leonard Spangher, CEBS
Vice President and Senior Consultant
Sibson Consulting
New York, New York
Agenda

- The Current Health and Welfare (H&W) Non-discrimination Testing (NDT) Landscape
  - Cafeteria Plan (Section 125)
  - Dependent Care Spending Account (Section 129)
  - Self-Insured Health Plan (Section 105(h))
  - Group Term Life Insurance (Section 79)
  - Others (Sections 127, 137, 223 and more)

- **Section 2716 of the ACA**
  - Our initial understanding of how to perform this
  - Penalties on employers
  - The first official testing requirement
  - What this might become
  - Why would *this* be the one to trigger audits?

- The Domino Effect
- Pitfalls and Red Flags
The Current Health and Welfare (H&W) Nondiscrimination Testing (NDT) Landscape

So What Steps Are You Taking?
The Current Health and Welfare (H&W) Nondiscrimination Testing (NDT) Landscape

• What is H&W NDT?
  – Mathematical and non-mathematical testing performed to ensure that Highly Compensated Employees (HCEs) and other prohibited classes are not favored over Non-Highly Compensated Employees (NHCEs) with regard to paying for and receiving pre-tax (and some taxed) benefits from qualified health and welfare plans

• Testing generally described in the Internal Revenue Code (IRC, or regulations), is recommended to be performed annually (and is not mandated . . . yet!)
  – Best practice/due diligence: Perform these annually as (the IRC says) plans cannot be discriminatory

• If a plan is deemed discriminatory, then it has tax implications for the prohibited class and/ or the plan sponsor, but there is no provision for plan disqualification like that of a retirement plan

Plans that are found to be discriminatory where testing is not performed by the plan sponsor are treated less favorably by the IRS, so make a good faith effort to show your plans are in compliance
The Current H&W NDT Landscape (continued)

• **So if not yet required, why test?**
  – Fairness to employees
  – Compliance with IRS regulations
  – Defense in an IRS audit
  – Impending requirement
    • Section 2716 of the ACA is indefinitely suspended until guidance can be provided

• **So what are the major tests performed today?**
Today’s Checklist

IRC Section 125: Cafeteria plans (based on 2007 Proposed Regulations)

• **Possible plan components**
  – Premium conversion plans (POP, or Premium-Only Plans) for H&W insurance
  – Account plans (Health FSAs, DCSAs, and HSAs)
  – Other: Adoption assistance, 401(k)s, Opt-out plans, COBRA

• **Checklist of what should be performed**
  – Eligibility test
    • 1 math and 1 facts and circumstances test, and 2 additional facts and circumstances tests (under proposed regs from 2007)
  – Nondiscrimination in operations test (under proposed regs)
    • Facts and circumstances test
  – Contributions and benefits test
    • 1 fact and circumstances test, 2 math tests (2nd is proposed regs)
  – Key employee concentration test
    • Math test
Today’s Checklist (continued)

IRC Section 129: Dependent Care Spending Accounts (DCSAs)

• Only component is the DCSA (or DCAP, DCRA)

• Checklist of what should be performed
  – Eligibility and availability test
    • 1 math and 1 facts and circumstances test
  – Contributions and benefits test
    • Facts and circumstances test
  – 55% average benefits test
    • Math test
  – 25% concentration test
    • Math test
Today’s Checklist (continued)

IRC Section 105(h): Self-insured Health / Health Reimbursement Plans

• Possible plan components
  – “Health Plans” refers to medical, prescription drug, dental, and vision plans
  – “Health Reimbursement Plans” refers to health FSAs and HRAs (does not include DCSAs or HSAs)

• Checklist of what should be performed
  – Eligibility test
    • Facts and circumstances test and/or math test (must pass 1 of 3)
  – Benefits test
    • Facts and circumstances test (5-pronged)
IRC Section 79: Group Term Life Insurance (GTLI) Plans

- **Possible plan components**
  - GTLI plans, including separate Executive GTLI (if it exists)
  - Voluntary/supplemental GTLI

- **Checklist of what should be performed**
  - Straddling the Table I Rates test
    - Math test to determine if voluntary/supplemental GTLI can be excluded from testing
  - Eligibility test
    - 2 Facts and circumstances tests and/or 3 math tests
  - Benefits test
    - 2 Safe Harbors or a facts and circumstances test
Other IRC Sections of Note

- Education Assistance Programs (Section 127)
- Adoption Assistance Programs, if outside of the Cafeteria plan (Section 137)
- Comparable Contributions Tests for Health Savings Accounts (HSAs), if outside of the Cafeteria plan (Section 223)
- There are other Sections of The Code that say plans must not discriminate in favor of highly compensated individuals (ex. Sect. 117–Qualified Tuition Reductions, Sect. 132—Fringe Benefits, incl. Transportation Benefits)
Section 2716 of the ACA
How We Envision This Being Tested (Initially)

• Section 2716 of the ACA outlines testing similar to Section 105(h)
• Section 105(h) was written to ensure that Self-Insured Health Plans do not discriminate in favor of Highly Compensated Employees
• Types of discrimination these regulations address include:
  – Eligibility
  – Benefits
  – Discriminatory in Operations
• Self-insured health plans should always be tested under Section 105(h) because there are always HCEs based on the definition within the Section
How We Envision This Being Tested (Initially) (continued)

- **Exclusions from the Eligibility Test MAY include:**
  - EEs with under 3 years of service;
  - EEs who have not attained age 25;
  - Part-time or seasonal EEs;
  - Collectively bargained EEs; and
  - Non-resident aliens who receive U.S. source earned income

- **Exclusions from the Benefits Test MAY include:**
  - Any of the groups listed in the Eligibility exclusions above, given the entire group is not participating in the benefits
  - It is not clear in the regulations whether they carry over from the eligibility test
Definitions:

• **Highly Compensated Employee (HCE) is defined under 105(h) as:**
  – One of the 5 highest paid officers; or
  – A shareholder with >10% of employer stock; or
  – Among the highest paid top 25% of all EEs

• **Officer is loosely defined under Treasury Regulations 1.416-1 (T-13):**
  – Administrative executive in regular/continued service, with executive authority and responsibilities
    • Authority defines Officer (not title)
    • Excludes Partners

• **Compensation** = (Box 5 of W-2) + (salary reductions for Cafeteria Plan and Transportation Plan)
Eligibility Test:

- The plan should not discriminate in favor of HCEs as to eligibility to participate.
- In order for plan to be nondiscriminatory as to eligibility to participate, a self-insured medical plan must benefit:
  - 70% or more of all (non-excludable) employees; or
  - 80% or more of all EEs eligible to benefit under the plan, if 70% or more of all EEs are eligible to benefit under the plan (thus participation can be as low as 56%, or 70% eligible and 80% of the 70% actually participate); or
  - EEs belonging to a classification set up by the employer and found to be nondiscriminatory (Classification Safe Harbor Test–410(b))

- You need only pass one of the three tests above to pass the Eligibility Test.
- The definition of “benefit” in the tests above is that an EE must have elected or been provided the particular coverage.
Reasonable Classification 410(b) Eligibility Test:

<table>
<thead>
<tr>
<th>Employee Category</th>
<th>Total EEs in Company (Non-Excludable)</th>
<th>Eligible EEs</th>
<th>Non-Eligible Non-Excludable EEs</th>
<th>Non-Highly Compensated Employee Concentration Percentage</th>
<th>Safe Harbor %</th>
<th>Unsafe Harbor %</th>
<th>Plan’s Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Highly Compensated</td>
<td>236</td>
<td>235</td>
<td>1</td>
<td>74.97%</td>
<td>38.75%</td>
<td>28.75%</td>
<td>93.32%</td>
</tr>
<tr>
<td>Non-Highly Compensated</td>
<td>707</td>
<td>657</td>
<td>50</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>943</td>
<td>893</td>
<td>51</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- Census is split by HCE and NHCE and EE counts are in the 1st column
- Those in 1st column who are eligible to benefit from the pre-tax benefit (and non-excludable) are summarized in the 2nd column
- Those in the 1st column who are not eligible to benefit from the pre-tax benefit (and non-excludable) are summarized in the 3rd column
- NHCE Concentration Percentage (column 4) is equal to the non-excludable NHCEs divided by the sum of the non-excludable NHCEs and HCEs. In the example, $707 \div 943 = 74.97\%$

PASS!
### Reasonable Classification 410(b) Eligibility Test:

<table>
<thead>
<tr>
<th>Employee Category</th>
<th>Total EEs in Company (Non-Excludable)</th>
<th>Eligible EEs</th>
<th>Non-Eligible Non-Excludable EEs</th>
<th>Non-Highly Compensated Employee Concentration Percentage</th>
<th>Safe Harbor %</th>
<th>Unsafe Harbor %</th>
<th>Plan’s Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Highly Compensated</td>
<td>236</td>
<td>235</td>
<td>1</td>
<td>74.97%</td>
<td>38.75%</td>
<td>28.75%</td>
<td>93.32%</td>
</tr>
<tr>
<td>Non-Highly Compensated</td>
<td>707</td>
<td>657</td>
<td>50</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>943</td>
<td>893</td>
<td>51</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- The Safe Harbor and Unsafe Harbor Percentages in columns 5 & 6 can be found by indexing the NHCE Concentration percentage on safe harbor table in Treasury Regs Section 1.410(b)-4(c)(4)

- The Plan’s Ratio equals (NHCEs who are eligible ÷ all non-excludable NHCEs) ÷ (HCEs who are eligible ÷ all non-excludable HCEs). In this example; 
  \[(657 ÷ 707) ÷ (235 ÷ 236) = 93.32%\]
Reasonable Classification 410(b) Eligibility Test:

<table>
<thead>
<tr>
<th>Employee Category</th>
<th>Total EEs in Company (Non-Excludable)</th>
<th>Eligible EEs</th>
<th>Non-Eligible EEs</th>
<th>Non-Highly Compensated Employee Concentration Percentage</th>
<th>Safe Harbor %</th>
<th>Unsafe Harbor %</th>
<th>Plan’s Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Highly Compensated</td>
<td>236</td>
<td>235</td>
<td>1</td>
<td>74.97%</td>
<td>38.75%</td>
<td>28.75%</td>
<td>93.32%</td>
</tr>
<tr>
<td>Non-Highly Compensated</td>
<td>707</td>
<td>657</td>
<td>50</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>943</td>
<td>893</td>
<td>51</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- Any Plan Ratio \( \geq 50\% \) automatically passes
- Plan Ratios \( \geq \) the Safe Harbor % passes
- Plan Ratios \( \geq \) Unsafe Harbor % and \(< \) Safe Harbor % are deemed as borderline pass/fail and would need to additionally pass a Facts and Circumstances test in order to be considered passing
- Plan Ratios \(< \) Unsafe Harbor % are considered failing the eligibility/classification test
• **Special Eligibility Rule for HMOs:**
   For Eligibility testing only, an HMO can be treated as if it is a self-insured plan if it meets the criteria of being optional and having the employer’s contributions for the HMO equal to or greater than someone in the self-insured plan. This does not apply to the benefits test.

[Note: We are not sure how this will translate in the fully-insured testing environment. It likely no longer would need to exist under Section 105(h), so it may lose its relevance]
Benefits Test:

- Non-mathematical test that is meant to ensure there is not discrimination in favor of HCEs with regard to benefits on the face of the plan and in operation/administration
- Includes meeting 5 facts and circumstances requirements:
  - Employee contributions must be identical for each benefit level
  - Maximum benefit level cannot vary based on age, service, or compensation
  - All benefits available to HCEs must also be equally available to NHCEs
    - Type of benefits
    - Amount of benefits
  - Disparate waiting periods cannot be imposed
  - Benefits under the self-insured plan cannot be discriminatory in operation in favor of HCEs
How We Envision This Being Tested (Initially) (continued)

- Sanctions for failing under Section 105(h):
  - The sanction for failing the Eligibility Test is that excess reimbursement will be taxed for each participating HCE. Excess Reimbursement % = Total HCE Reimbursements ÷ Total EE Reimbursements. That % of HCE benefits would be taxable. Additionally, the penalties in Section 125 could also apply, if also failing those tests.
  - The sanction for failing the Benefits Test is that all reimbursements (all self-insured medical benefits) above those for NHCEs would be taxable to the HCEs under Section 105(h), and not just the pro-rata share of excess benefits as in the case of failing the eligibility test. If a benefit is offered to HCEs and not to NHCEs, the entire benefit would be taxable for the HCEs.

- The plan does not lose qualified status if it fails.

- Any corrections made to the plan(s) will impact the following year.
• **Example 1: Eligibility Test Sanction:**
  - Company X has a self-insured PPO. Employees contribute 20% of the cost of coverage (or $2,000 of the $10,000 cost for single coverage). There are 200 employees. The plan is provided to only 120 of the 200 employees. Assume the plan fails their Eligibility Test
  - A Highly Compensated Individual (HCI) (let’s call her Judy) has $90,000 worth of claims covered by the plan (“reimbursed”). The plan paid out $350,000 worth of benefits to all (120) employees. Of the $350,000 in total, $260,000 was paid out for HCIs
  - The amount that must be included in Judy’s taxable income is: 
    \[ \left( \frac{260,000}{350,000} \right) \times 90,000 = 66,857 \]
    All HCIs would be taxed at 74.3% of their covered benefits (or reimbursements)

• **Example 2: Benefits Test Sanction:**
  - Company Y provides a self-insured medical plan that covers all employees. There is a benefit maximum of $5,000 for Officers, and $1,000 for all other employees (which clearly violates the Benefits Test). All HCI benefits above the $1,000 would become taxable income. If William (an HCI) receives $4,000 worth of covered benefits, then $3,000 would need to be added to his taxable income

If either plan were also administered through a Cafeteria plan, failing the Section 125 Eligibility Test would also have tax implications, and IRS apportionment rules would need to be followed
Penalties on Employers (New!)

Sanctions for failing under Section 2716 of ACA:

• Section 105(h) sanctions on self-insured plans would not apply to fully-insured plans

• New sanction for non-grandfathered plan failing either Eligibility or Benefits Test under Section 2716 is defined by Section 4980(D) as:
  
  − Excise Tax: Valued at $100 per day of noncompliance “with respect to each individual to whom such failure relates” [IRC 4980(D)(b)(1)]. This is $100 per day multiplied by total number of NHCEs who do not get same favorable benefits as HCEs
  
  − There is a maximum tax limit of $500,000
  
  − Plan sponsor may be subject to additional civil action to compel nondiscriminatory benefits
The First Official Testing Requirement

- Current H&W nondiscrimination regulations say plans cannot be discriminatory—They do **NOT** require testing (yet)
- The 2007 Proposed Section 125 regulations require annual testing at the end of the plan year, using data cut on the final day of the plan year
  - Just proposed, not final, so not required to follow these yet
- **Section 2716 of ACA requires annual testing**
  - Does not specify timing, or data to use
  - Guidance is pending as this reg. is suspended indefinitely
What this Might Become

• Both Eligibility and Benefits Tests could remain similar to those for Section 105(h), however, the IRS could . . .
  – Revamp the definition of Highly Compensated
  – Eliminate the 70% and 80%/70% rules under the Eligibility Test and only require the 410(b) Nondiscriminatory Classification Test
  – Simply make the Benefits Test the same as Section 105(h)

• Sanctions would be different
  – Employee benefits would be taxed under Section 105(h)
  – Only Employer pays an excise tax penalty under Section 2716

  • This is because for fully insured plans, everyone gets the same benefit/contribution levels within the same plan—There is no excess benefits or contributions to tax
• Requirements as to when to test, and what data is required to perform the testing

  – The most recent Proposed Section 125 guidance would suggest:
    • Plan testing be performed after the end of the year, performing the test retrospectively
    • Historical Data is used—Captures all those eligible throughout the year
  – However . . .
    • Prospective testing using snapshot data (similar to Section 129 testing) could be possible here, given there is no true benefit utilization test. No benefits need aggregating or accumulating
      – More importantly, the penalty is based on how long the plan has discriminated, so plan sponsors should at least test this early in the year to catch any obvious problems
Why Would *This* Be the One to Trigger Audits?

- Testing is required, so everyone must have proof
- IRS is expected to clarify Section 105(h) and Section 125 regulations as well
- Employer penalties (of up to $500,000) could be significant income to pay for audits and ACA funding
- IRS will want to find a few large employer examples to scare others about possible audits
- Given current lax testing environment, and clarity of current regulations, IRS could see significant non-compliance across various H&W benefit plans

So this could go beyond audits and also trigger . . .
The Domino Effect
Nondiscrimination Testing Mandates

• **Section 2716 indicated testing is required annually**
  – Pension (401(k)) Testing is required to be performed annually (if not a safe harbor design)
  – 2007 Proposed Section 125 regulations require annual testing
• **Section 105(h) self-insured health plan testing will likely follow suit**
• **ACA delayed the IRS from issuing guidance, making the 2007 Proposed Section 125 regulations final—Proposed regs required annual testing**
• **That leaves Section 129 (and perhaps Section 79) as the only major H&W Sections to not be mandated—These would be last to follow**
Pitfalls and Red Flags: What Might Raise an Eyebrow at the IRS?

- Employees with different benefits (or cafeteria plans) offered (by individual or by division)
- Employees that pay different amounts for the same benefits
- Employees with no benefits offered or certain benefits not offered (and work more than 30 hours/week)
- Any employee treated differently in a plan document or in the operation and/or administration of the plan
- Executive (or Top Hat) plans
- Employees with different benefit waiting periods, entry dates, or delays (medical plans cannot have a longer waiting period than 90 days by law)
- Mergers and acquisitions without testing
- Changing assumptions and/or exclusions from year to year
- Make sure to separate and independently test Controlled Groups—Use classification testing
Section 105(h) and, as it stands, Section 2716, will always have HCEs
  - So there is always something that can be tested

Remember to index definitions of HCE and Key Employee when testing

Section 129 55% Average Benefits Test and Section 125 Key Employee Concentration test are always run in aggregate
Final Thoughts: What Will Come to Pass

• The Presidential election could change everything
• If ACA still exists, testing of some kind will be required
• Could likely cause domino effect
• Before ACA testing is mandated, check your plans at least once—Make sure they all comply according to the tests discussed today
• Even if not audited for nondiscrimination reasons, the IRS could ask for your proof of compliance

... and Death and Taxes ...
Key Takeaways

- So you have a checklist of current tests to ensure they are all being performed (or are under consideration)
- The new penalties will apply to the plan sponsor (and they are big)
- Look for those pitfalls and red flags among all of your health and welfare plans